Global Equity Views
Themes and implications from the Global Equity Investors Quarterly

In brief

• Despite widespread pessimism about the economic outlook, stocks have had a pretty good year so far, with the U.S. and Japan leading and China the only major disappointment. Resilient corporate profits have been the key, together with enthusiasm over the potential for artificial intelligence (AI) to boost profits even further.

• Valuations for most stocks still look reasonable to us, except in the most popular areas of the global equity market. The gap between high and low priced stocks has been narrowing for almost three years when looked at broadly across markets.

• Our investors favor quality industrial and technology companies but remain cautious about paying too much for the “expensive defensive” groups. Many investors are looking to closely manage style risk in portfolios, given the rather uncertain macro outlook, and are focusing even more than usual on stock selection as the driver of returns.

Taking stock

Equity markets have generally continued to perform well since our last quarterly. The widely predicted U.S. recession has yet to arrive, and corporate profits have been very resilient, at least in nominal terms. The exceptional performance of technology stocks, inspired by talk of an AI revolution, has grabbed the headlines, but beneath the surface, valuation metrics are working well across most markets.

Since the March failure of two U.S. regional banks (along with the collapse of Credit Suisse), the financial sector has also proved resilient. China’s market remains the major source of disappointment for equity investors, with continued struggles in the real estate sector overshadowing the post-COVID economic recovery, and unease over the government’s domestic and foreign policies.

After a strong year so far, our portfolio managers are taking a somewhat conservative view of the outlook, with average rather than strong returns in prospect. Uncertainty over profits is the major reason; the dynamics of the post-COVID economy are still complicated and make forecasting unusually difficult. The other source of concern is monetary policy, as inflation is proving more stubborn than expected. Valuations look reasonable in most regions. The obvious exception is the premium again awarded to U.S. technology, but it is not at all extreme by historical standards.

In portfolios, we continue to have a strong bias toward quality stocks—companies with higher margins, strong balance sheets and proven
management teams. We find many good examples in the technology and industrial sectors, while the classic defensive consumer staple and utility stocks still look highly priced and less interesting.

We continue to take a skeptical view of many “pre-profit” companies that were so popular in 2020–21, even at drastically reduced prices. Overall, this seems like a good time to rebalance, diversify and look for fresh opportunities outside the narrow list of mega cap technology winners that investors have gravitated to this year (Exhibit 1).

Profits holding up well despite higher rates

After second quarter earnings reports have been completed, we expect almost the same overall profits for global corporations that we forecast at the start of the year. In the U.S., numbers have been strong as the economy has continued to expand and companies have been able to raise prices. Results now reflect the impact of the COVID boom (and subsequent bust in some areas, such as health care), and one could argue that we have already seen a profit recession rolling across many industries during the past two years.

Next year, the drag from lower energy profits should fade, the cyclical areas of technology should reaccelerate, and some big unprofitable companies (for example, Uber) should move into the black. This all adds up to a forecast of double-digit earnings growth—admittedly, a forecast that makes us slightly uncomfortable (Exhibit 2). A recession and/or delayed reaction to Federal Reserve tightening would, of course, spoil this benign outcome. But fundamentally, U.S. corporations look to be in great shape, continuing to grow despite higher rates.

Health care innovation: Exciting new paradigm or overhyped bubble?

In an otherwise rather dull year for the health care sector, excitement over the potential of anti-obesity drugs has been a real bright spot. Shares in Eli Lilly, maker of Retatrutide, are up more than 70% over the last year, making the company one of the top 10 in the world by market value. And in Europe, shares in Novo Nordisk, maker of Ozempic, are up 80%. Investors expect anti-obesity drugs to hit USD 100 billion in sales by 2030, led by the U.S. market.

Is this an exciting new paradigm or an overhyped bubble? That is a spirited debate. And although the sector fundamentals are, of course, very different, AI stocks are the subject of a similar discussion.

In the pharmaceutical space, growth-oriented investors point to the exceptional potential of anti-obesity drugs to transform the treatment of a major global epidemic, and remind us of the critical importance of not missing major trends. Value investors struggle to model the potential benefits aggressively enough to make sense of current sky-high valuations. They also worry over patent longevity and the availability of enough government-funded health care spending to fully realize the drugs’ potential.
For both AI and anti-obesity drugs, most of our core portfolio managers are staying invested in the winners and managing risk carefully. In pharmaceuticals, we are closely watching for clear signposts on drug safety, the desire of governments and private payers to fund adoption, and greater manufacturing capacity.

China: Disappointing returns—time to ask what could go right

It is now obvious to investors that the expected revival in the Chinese economy and stock market as COVID restrictions were lifted has been a disappointment. Consumer spending did indeed bounce back, but this benefit has been far outweighed by longer-term, more structural issues.

Real estate markets continue to cool after a decade-long boom peaked in 2021, leaving many developers in financial distress and individual investors highly risk averse. In addition, the government’s continued intervention in the private sector and rising tensions with other nations are causes of concern for investors. We see little reason to expect these problems to be resolved anytime soon, and profit forecasts have been dropping all year along with stock prices.

Still, our portfolio team flags two important caveats to this view. First, just about everybody is now bearish on Chinese equities. The market is down 50% from 2021 highs, and valuations are closer to historical lows (if not quite there yet). Amid such negative sentiment, it’s a good time to ask what could go right.

Second, the Chinese market remains by far the broadest and deepest in the emerging market universe, with a huge range of liquid companies and a high level of volatility (Exhibit 3). That combination offers great opportunities for stock pickers to profit. To be sure, the picture is more complicated this year,

China is a high dispersion market with lots of liquid stocks

Exhibit 3: Number of stocks trading at least USD 2 million/day and dispersion of annual return

Source: MSCI.
as underperforming state-owned enterprises have come into fashion. But we find no shortage of well-managed growth companies at sensible valuations.

Exhibit 4 shows the views of our team members. Overall, they remain cautious, prefer quality and industrial stocks and look to manage style risk in portfolios.

Views from our *Global Equity Investors Quarterly*, September 2023

Exhibit 4

Source: A subset of results is shown from a September 2023 survey of *Global Equity Investors Quarterly* participants. These responses are taken from a quarterly survey representing 30 CIOs and portfolio managers across global equities.

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